Capital Markets Union (CMU): Insolvency Law Chapter

The European Parliamentary Financial Services Forum (EPFSF) (see https://www.epfsf.org/) facilitates and strengthens the exchange of information on financial services and Europe's financial markets between the financial industry and Members of the European Parliament. On January 25, 2017 a lunch event on "Capital Markets Union (CMU): Insolvency Law Chapter" was organised. The intent was to discuss five questions, formulated below.

The following short notes formed the basis of the responses of prof. Bob Wessels.[1]

1 Are more harmonised European Insolvency laws necessary? Do you believe that these issues would be best left to national regulators and insolvency regimes?

Pros/cons of harmonisation[2]
Harmonisation on insolvency laws does not come out of the blue, as a total surprise. In the EU there have been general trends of convergence in corporate issues since the 70s, in the last decade many Member States have converged their insolvency law frameworks (often inprired by US's Chapter 11), in the EU Insolvency Regulation 1346/2000, to be replaced by the recast 2015/848, in force as from 26 June 2017, one sees convergence in private international law re insolvencies, even 'creeping harmonisation', in the form of uniform rules on some 10 themes, including cross-border coordination in restructuring and insolvency cases for insolvency practitioners and court. These matters therefore are uniformely regulated in all Member States (except Denmark). Finally, the reform mania is global by new restructuring rules pending ore introduces in Australia, Japan and India.

Downsides of harmonisation[3]:
(i) Harmonisation results in the loss of national peculiarities of insolvency law;
(ii) By harmonisation, countries lose the chance to enter into regular competition to create better law systems in which countries learn from each other;
(iii) Harmonisation of substantial insolvency law will lead to a MS losing the dynamic effects of national legislative competition, on the one hand, but individual countries will also be confronted with an extreme slowing down of the process of amending the law and the possibility of adapting this law;
(iv) Leads to mixed system: EU system and national system;
(v) MSs see insolvency rules and proceeding as 'public' domestic domain, as these rules protect interests the MSs values most, especially regarding distributions

Observing these alledged downsides:
(i) business insolvency cases require efficient case management and that the principle of equality of arms is fully observed; not all national procedural folklore is meaningful;

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[2] For a short introduction to the Proposal, see my blog on http://leidenlawblog.nl/articles/proposal-for-a-restructuring-directive.
[3] See the report presented the the Dutch Assiciation of Civil Law, written by Ian F. Fletcher and Bob Wessels, Harmonization of Insolvency Law in Europe, Deventer: Kluwer 2012, and see http://bobwessels.nl/2016/01/2016-01-doc5-to-harmonise-or-not-to-harmonise-insolvency-laws-in-the-eu-is-that-a-question/

(ii) ‘better’ national law, as the result of regular competition, does not exclude the possibility that the results of harmonisation will be even better (under the condition that it is possible to even formulate what ‘better’ is);
(iii) seems to purely focus on (hard) law, overlooking the fact that the legal rules surrounding businesses in financial distress also could be drafted in a more flexible way, allowing judicial discretion, in a field where there is hardly one single solution, many times in a process with many parties of interest and where only private money is involved;
(iv) it’s part of the EU deal.
(v) an effective insolvency regime is a key component of the internal market, a free market economy that values entrepreneurship and competition. Restructuring is a business problem and starts off with business/market negotiating solutions. It must be noted, however, that the parties involved in this restructuring have expressed a general consent to further approximation/harmonisation of insolvency and restructuring regimes across Europe.
See Q3.

Q2 In your view, does the legislative proposal on insolvency go far enough to address the problems of divergent national insolvency regimes cited by the European Commission?

UNCITRAL already in 2004: with all national insolvency systems, having so many differences, these ‘… hamper the rescue of financially troubled businesses, are not conducive to a fair and efficient administration of cross-border insolvencies, impede the protection of the assets of the insolvent debtor against dissipation and hinder maximization of the value of those assets. Moreover, the absence of predictability in the handling of cross-border insolvency cases impedes capital flow and is a disincentive to cross-border investment …’

The EC has chosen the right basis in Basis in 114 TFEU
In the business world of trade and investment, insolvency law is a main pillar of market economy. The view prevails that insolvency has become a calculable and acceptable risk and that and businees failure and market exit is an integral part of the business cycle. Many countries understand the importance a solid insolvency system and its meaning for a growing economy.

Setting up (option 4) a harmonised minimum legal preventive restructuring framework has been given some 20 benefits (see p. 18/19 Proposal). My criticism:

1 Its basis is weak
Its economic / policy assumptions are questionable. CMU plan is build on assumptions of the World Bank that have been severely criticised (Leeds Report 2016) and the Impact assessment has been called ‘… superficial, methodologically unsound and, in any case, is clearly driven by the motive of supporting the Commission’s preferred regulatory course.’[4]
EC seems to copy the Chapter 11 process, generally used as example, which in itself in the USA is subject of criticism. The Proposal lacks that restructuring proceedings have (like in Chapter 11) strong judicial governance.

2 Proposal does not go far enough

4 Horst Eidenmüller, Contracting for a European Insolvency Regime, January 2017, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2896340

a Addition possible for at least 2 other tools: (ii) an ‘asset deal’ and (ii) a swift sale as going concern to a third party – at arms’ length – under private agreement or via an auction as alternative.

b Strengthen restructuring arena, with experienced courts (centralising; concentrated) and stricter, binding professional and ethical rules for IPs and Pifors (See Article 2(15)).

c For a good and efficient EU harminisation model, several matters are lacking: (i) limited judicial oversight, (ii) no tool to correct fraudulent behaviour in vicinity of the preventive restructuring ‘start’, (iii) lack of clarity on how new finance should be protected, i.e. what priority should be granted, (iv) no rules for ranking claims, (v) no rules to harmonise criteria for avoidance actions, (vi) no nubstantial rule for director’s liability, (vii) no rule for roviding information to creditors/employees.

3 Does the proposal do enough for ‘common citizens’?
Proposal shall not apply to five types of financial institution, and also not (Article 1(2)(g)) to ‘natural persons who are not entrepreneurs’. Article 1(3) says that MSs may extend the application of the procedures referred to in Article 1(1)(b) (discharge) to overindebted natural persons who are not entrepreneurs. Why not a more equal European approach? Why not a distict Directive for ‘insolvency’ for citizens?

Q3 The legislative proposal still needs to be negotiated with the European Parliament. Do you see any impediments or obstacles to approving the legislative proposal?

1 The Proposal’s aim is blurred
The stated objective of the Directive is to ‘... remove obstacles to the exercise of fundamental freedoms, such as the free movement of capital and freedom of establishment, which result from differences between national laws and procedures on preventive restructuring, insolvency and second chance. This Directive aims at removing such obstacles by ensuring that viable enterprises in financial difficulties have access to effective national preventive restructuring frameworks which enable them to continue operating …’ (Recital 1). At the same time, its aim is to have restructuring frameworks available that ‘... should also prevent the build-up of non-performing loans’ (Recital 2). Is its focus on ‘save viable businesses’ or on creating benefits for banks?

2 Text rather general, with vague terms
In general: vague terms jeopardise the legal effectiveness of the proposal.
An example being ‘likelihood of insolvency’, which is in particular vague as it is inluded also in the EIR Recast, which has already been approved by the EP (see Article 1(1) EIR 2015 and recital 10) and is as term specifically qualifying (i) the general availability of a preventive restructuring framework (Article 1(1)(a) jo. Article 4(1), (ii) for the position of equity holders (Article 12(1), and (iii) as a trigger for several duties for directors (Article 18).

To mention just some other vaguaries ‘(…) valuation (…) of the debtor’s business’, and ‘(…) a restructuring plan which would restore the viablity of the business’, ‘viable’ (8(1)(g)).
Is there a difference between ‘fraudulently or in bad faith’ (Article 16) and ‘dishonestly or in bad faith (Article 22(1)(a))

3 Implementition guidance / Guide to enactment

By providing more detail / MSs should better coordinate implementation efforts, step out of the zone that ‘all restructuring and insolvency is an isolated prerogative’ of a MS.

A Art 18 - changes in duties of directors will be difficult to implement as they are related to all legal persons with a business intent or legal persons with a non-profit goal.
Who is ‘director’ in case of mixed boards (directors and non-executive directors)?

B Overindebted entrepreneur (Article 2(13)) will receive a full discharge (19(1) and 2(14)) after 3 years (20(1)), but MS may derogate (22) from 19-21. Does it include a ‘natural person’ establishing a company and providing suretyship (Bürgshaft) for a loan to the company?

C Art 5 – DIP (is not defined, but see Article 2(3) EIR 2015). How to deal with frictions with ‘national definitions of ‘DIP’. DIP is the (wo)man in charge, no appointment or ‘judicial or administrative authority’ or ‘Pifor’ (2(15)), unless 5(3) MS may require appointment (in case of stay or cross-class cram-down). Note Pifor has a task (2(15)), but ‘authority’ does not)

D Article 16 re protection for new and interim finance (defined in 2(11) and 2(12) exempted from ‘civil, administrative and criminal liability’. Does this include (i) general civil transaction avoidance rules, (ii) a claim for financial damages on a non-liability ground, or (iii) corporate law liabilities?
In Proposal no differentiation between ‘external’ and ‘internal’ financing; will internal (inter-company) finance be compatible with national rules re subordination?

Q4 What do you see as the main benefits of more harmonised insolvency laws across Europe?

The Proposal is not disruptive or utopian. Proposal fits in tendency
-from being rather exclusively to protect the creditors’ private law interests, to being deployed for rehabilitation of the debtor and *the continuity of its business* (increased group of interested stakeholders),
-from viewing insolvency as a terminal proceeding for business ending in liquidation, to the recognition of insolvency proceedings as a gateway to potential business rescue (‘*instrumentalisation’* of insolvency law),
-from insolvency being seen as a personal sin (morale failure), to have developed to insolvency seen as a business risk (*economic failure*) (enhancement of a rescue culture), and
-from a formal legal procedural approach to an openness for flexible and pragmatic choices (‘*deformalisation*’, sometimes ‘*contractualisation*’ of insolvency).
This should lead to the development to the distinct body of business rescue and insolvency law. It is submitted that this law indeed can assist in the restructuring of the economy and the allocation of assets from within the private sector.

Benefits:
-Closes gap between MSs existing systems.
-Significantly reduces the ability of shareholders and ‘out of the money’ creditors to hold-out, to block reasonable, real ‘viable’ restructuring proposals.
-Many term and expressions will get an ‘autonomous European’ interpretation, such as overindebtedness, safeharbour provisions, the term ‘impartial independent and competent’ for a Pifor.
-Training for IPs.

-Voluntary codes
-Electronic means in (Article 28)
-Datacollection (Article 29) to keep track with measures themselves.
There will be costs and administrative burden involved, but must be weighted against the result: an improved understanding on how restructurings work and general societal benefit.

5 What are the most important negative effects of more harmonised insolvency laws across Europe? And how can they be mitigated?

See Q1

A Lack of national ‘national parliamentary’ involvement, but (i) restructuring is a business/market problem, (ii) ‘insolvency’ hardly ever high on national policy agenda, unless related to natural persons/household debts. Mitigated? By Committee (Article 30) and independent pan European observers?

B Troublesome regulation of IPs. How about Pifors? Delegate strengthening profession of IPs/Pifors to a European agency, including ombudsman

C Lack of flexibility, which is desireable considering the peculiarities of resolving individual businesses in financial distress. This lack of flexibility may arise when the EU legislator directs its efforts solely (or too much) at introducing harmonised hard law, ignoring soft law or self-regulation mechanisms.

D Banks and their lobbies will be resistent

E Building a rescue culture?
The European Commission is ambitious and optimistic: ‘Boosting jobs and growth in Europe requires *a stronger rescue culture* which helps viable businesses to restructure and continue operating while channelling enterprises with no chance of survival towards swift liquidation, and gives honest entrepreneurs in distress a second chance. This proposal is an important step towards such a change of culture’.
This surely means that legislation itself may not only be an appropriate policy response, it should trigger the insolvency market (lawyers, accountants, courts, lenders, and indeed politicians) to act as vectors of this culture.